United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLANT

ORIGINAL

77-7082

To be argued by
SCOTT E. MOLLEN

United States Court of Appeals

FOR THE SECOND CIRCUIT

BRITTA DANIELS as Trustee of the Testamentary Trust under the Will of HENRY DANIELS, Deceased, and BRITTA DANIELS, individually,

Plaintiff-Appellant,

v.

ERNST & ERNST,

Defendant-Appellee.

UNITED STATES COURT OF APPEALS
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A. DANIEL FUSARO, CLERK
SECOND CIRCUIT

ON APPEAL FROM THE UNITED STATES DISTRICT COURT OF THE SOUTHERN DISTRICT OF NEW YORK.

BRIEF FOR PLAINTIFF-APPELLANT

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United States Court of Appeals

FOR THE SECOND CIRCUIT

BRITTA DANIELS as Trustee of the Testamentary Trust under the Will of HENRY DANIELS, Deceased, and BRITTA DANIELS, individually,

Plaintiff-Appellant,

v.

ERNST & ERNST,

Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT OF THE SOUTHERN DISTRICT OF NEW YORK.

BRIEF FOR PLAINTIFF-APPELLANT

Plaintiff appeals pursuant to 28 U.S.C. §1291 from an order of the United States District Court for the Southern District of New York (Frankel, J.) which granted defendant's motion for summary judgment dismissing the complaint on the ground that the applicable statute of limitations had run (349a-350a)*. Judge Frankel wrote an opinion which appears at pages 341a-348a of the Appendix, of which more later.

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* Numbers in parentheses refer to pages of the Appendix.

Nature of the Action

Plaintiff, individually and as a trustee of a testamentary trust under the will of her late husband Henry Daniels, seeks damages sustained as the result of violations by defendant of Securities Exchange Commission Rule 10b-5. In essence, plaintiff claims that defendant, an independent partnership of certified public accountants, was retained by Beck Industries, Inc. (hereinafter Beck) to conduct audits and render reports as to Beck's financial condition for the fiscal years 1968 and 1969 and that as the result of false and misleading reports and misrepresentations made by the said accountants, plaintiff's husband was induced to enter into a business deal with Beck (21a-31a)*.

Plaintiff claims that as a direct consequence of defendant's wrongdoing, plaintiff's husband sold his entire business to Beck through an exchange of stock in July, 1969, then valued at 4.2 million dollars, and suffered a virtual loss of that entire amount in a period of less than two years because of a virulent deterioration of Beck's financial condition resulting in Beck declaring bankruptcy in May, 1971 (30a-31a; cf. 342a-343a).

The Decision Below and The Issue On this Appeal

The Court below correctly held that a three year California statute of limitations was applicable, which period commenced on the date of discovery of the fraud or on

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* Plaintiff also asserted pendent state law claims based upon the same facts but framed in terms of fraud, gross negligence and breach of contract with Beck (31a-33a). With regard thereto, Judge Frankel held that "since plaintiff's federal claims have been decided adversely at this preliminary stage in the litigation, the Court finds it inappropriate to determine the status of the pendent claims." (348a)

the date the fraud should upon reasonable inquiry have been discovered (344a). The Court then ruled—incorrectly, we respectfully submit—that the statute of limitations commenced running no later than May, 1971 (the month Beck declared bankruptcy) and that the action, commenced in April, 1975 was time barred (345a).

Notwithstanding that the Court below expressly acknowledged that in May, 1971 "plaintiff and her husband may not have been aware of the details of Ernst & Ernst's allegedly fraudulent conduct" (347a), and despite plaintiff's sworn averment that neither she nor her husband learned "or ever suspected" that Beck's accountants had perpetrated a fraud until December, 1973 (321a, 324a), the Court nonetheless held as a matter of law that the mere fact that plaintiff and her husband knew in 1971 of Beck's financial difficulties leading to its bankruptcy constituted "sufficient notice that further inquiry into Ernst and Ernst's role would be prudent" (347a).

We contend that the issue as to when plaintiff and her husband discovered or should have discovered the fraud is a material question of fact precluding summary judgment (cf. *Friedlander* v. *Feinberg*, 369 F. Supp. 917 [S.D.N.Y. 1974], aff'd 508 F.2d 836 [2d Cir. 1975]; *Friedman* v. *Meyers*, 482 F.2d 435, 438-9 [2d Cir. 1973]; *Klein* v. *Auchincloss, Parker & Redpath*, 436 F.2d 339, 341-2 [2d Cir. 1971]).

The Court alluded to the fact that in 1970 and 1971 Beck's financial deterioration attracted the attention of the press (342a-343a). Defendant, in support of its motion, annexed 37 newspaper items generically discussing the subject (57a-61a, 87a, 98a-133a), *not one of which so much as made an oblique reference to defendant Ernst and Ernst or intimated that the independent firm of accountants had committed a wrong.*

Plaintiff concedes that she and her husband were aware of Beck's financial disintegration in 1970 and 1971 (323a) but that is a far cry from being alerted to a behind-the-scenes wrongdoing on the part of the independent firm of accountants. Secondly, the decision in *Friedlander* v. *Feinberg* (369 F. Supp. 917) supports the position urged by plaintiff herein that knowledge of the poor financial condition of a company in a later period does not as a matter of law constitute actual or constructive notice that the financial condition of the company in earlier years was misrepresented. Moreover, as discussed more fully *infra,* the newspaper reports clearly indicated that Beck's financial collapse was due to poor financial conditions (inflation, slowdown in the economy, "souring" of the stock market) and poor management (119a, 120a, 125a)—factors that would hardly excite a reasonable suspicion that Beck's independent firm of certified public accountants had mislead the public.

The Court below rejected plaintiff's claim that neither she nor her husband were sufficiently sophisticated regarding corporate investments to have had constructive notice of the fraudulent scheme for purposes of the statute of limitations (347a). The Court so ruled notwithstanding plaintiff's enumeration of various factors in sworn statements that would clearly support a finding that neither she nor her husband possessed the necessary degree of sophistication to have been put on notice (136a-139a, 142a, 149a, 161a-162a, 173a-177a, 321a-323a). The Court also appears to have completely overlooked the very practical consideration that from 1969 until his death in December, 1973, Mr. Daniels "was extremely ill and was forced to curtail whatever business related activities he was engaged in. He was then suffering from arterial sclerosis which in fact was the cause of his death in December of 1973" (323a).

We contend that the issue as to the degree of business sophistication possessed by plaintiff and her husband is a material question of fact precluding summary judgment (cf. *Dzentis* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 494 F.2d 168, 172 [10th Cir. 1974]).

The Court below noted that in 1970 Mr. Daniels, upon hearing of the suspension of trading in Beck stock, stated to his wife that he had been "taken" and that Beck's financial condition had, in the Court's language, "been misrepresented in the various reports and statements provided to him in 1968 and 1969" (345a). Upon that basis the Court concluded that Mr. Daniels "actually believed that the information provided him about Beck's financial health had been inaccurate and misleading" (346a).

We contend that the meaning ascribed by Mr. Daniels to the word "taken" is ambiguous on this record* and gives rise to yet another issue of fact (cf. *Heyman* v. *Commerce And Industry Insurance Co.*, 524 F.2d 1317, 1320 [2d Cir. 1975]). It is manifestly unfair to dismiss this action in its nascent stage upon limited answers by a lay person (plaintiff) on a deposition to very constricted questions without having the subject matter fully aired (175a, 179a). The utterance may have had no real significance or, on the other hand, it may have indicated Mr. Daniels' belief that a wrong had been committed. This limited record by no means supplies the answer. It is hornbook law that all ambiguities must be resolved in favor of plaintiff (*Gladstone* v. *Fireman's Fund Ins. Co.*, 536 F.2d 1403, 1406; *Heyman* v. *Commerce And Industry Insurance Co., supra,* 524 F.2d at p. 1320).

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* It is not unusal to hear a dissatisfied purchaser colloquially assert in a fit of pique "I've been taken" or even "I've been robbed" without actually intending to use those terms in their literal sense.

We further contend that Mr. Daniels' utterances concerning misrepresentations in reports and statements does not, as found by the Court below, necessarily require the conclusion that Mr. Daniels was cognizant in 1970 that the financial data supplied by defendant herein was misleading as contrasted with statements and puffery of *Beck* personnel in the reports and statements (288a-292a). Our position is borne out by plaintiff's deposition (157a-158a) and her affidavit opposing the motion wherein she stated that "when Beck stock dropped so precipitously, we certainly suspected that the statements *made by Beck personnel as to Beck's being a 'great company' with excellent growth potential were inaccurate*" (323a; emphasis supplied). Again, precisely what Mr. Daniels meant gives rise to a question of fact that cannot be resolved on this record but rather requires amplification and elucidation upon a trial through any available and admissible evidence, testimonial or documentary (cf. *Jaroslawicz* v. *Seedman*, 528 F.2d 727, 731 [2nd Cir. 1975]).

Thus, the dispositive issue on this appeal is whether the Court below erred when it held that "there are no material facts in dispute" (341a) and granted defendant summary judgment on the ground that plaintiff and her husband had, as a matter of law, constructive notice of a wrongdoing in May, 1971, despite plaintiff's sworn statement that neither she nor her husband had any inkling of any wrongdoing by defendant until December, 1973 (321a, 324a). We respectfully submit that the Court did err.

The Facts

It is fundamental that on a motion for summary judgment the record must be viewed in a light most favorable to the party opposing the motion (*First National Bank of*

Cincinnati v. *Pepper*, 454 F.2d 626, 629 [2d Cir. 1972]). As this Court wrote in *Heyman* v. *Commerce And Industry Insurance Co.*, 524 F.2d 1317, 1320:

> "Moreover, when the Court considers a motion for summary judgment, it must resolve all ambiguities and draw all reasonable inferences in favor of the party against whom summary judgment is sought * * *."

Applying that standard to the instant case, the facts as we must assume them for purposes of this appeal are as follows:

Events prior to the 1969 agreement between Beck and Mr. Daniels

Mr. Daniels was the president and sole stockholder of Hartogs which consisted of two corporations engaged in the design, manufacture and sale of shirts to retailers (139a-142a). Notwithstanding that he had created a successful business, the record in no wise warrants the conclusion that he was a sophisticated investor or businessman.

On the contrary, his abilities ran to the artistic rather than the business end of his operation. He never attended college (138a) inasmuch as he pursued an acting career following high school (138a, 321a). His primary activity with Hartog involved the designing of materials and acting as a color coordinator (139a, 322a). He left the "business aspects" of running the firm to his father and, following the latter's death in 1959, to his accountants (322a). From the time of his marriage to plaintiff in about 1965 he was never a director or officer of any company other than Hartog (148a, 322a). He never made business in-

vestments in other companies apart from an occasional purchase of stock brought to his attention by and purchased on the advice of a stockbroker (322a).

Plaintiff expressed her opinion that she did not think her husband regularly read such publications as The Wall Street Journal, The New York Times, Women's Wear Daily, Forbes, Business Week, Fortune, Dunn's Review or other similar publications (322a). Plaintiff pointed out in her affidavit that from 1969 to the time of her husband's death in December, 1973, he was "extremely ill" from arterial sclerosis and was forced to curtail all business activities (323a).

Plaintiff was even less sophisticated business-wise. Prior to her marriage she had been an elementary school teacher in Sweden (137a, 322a). Following their marriage her sole occupation was housewife and mother (322a). She never became involved in Hartogs and never made any investments during the period (142a, 152a, 322a). While from 1968 to the present she received the Los Angeles Times, she never read it regularly nor did she ever read the publications discussed above (172a, 322a).

In 1968 representatives of Beck approached Mr. Daniels concerning the possibility of acquiring the stock of Hartogs (157a). Negotiations continued into 1969 during which time Mr. Daniels was provided with, inter alia, financial data prepared by defendant Ernst and Ernst who, as previously noted, had conducted audits and reported upon Beck's financial statements for the fiscal years 1968 and 1969 (37a, 157a, 162a-163a, 342a). Plaintiff testified that "from the reports * * * he [her husband] felt it was a great company" (159a). Mr. Daniels "was assured about that" (159a) by representatives of Beck who stated to him that Beck was a "great company" and in "a very sound financial condition" (157a-158a).

The agreement between Beck and Mr. Daniels

On July 1, 1969, Beck and Mr. Daniels entered into an agreement for the sale by the latter of all of Hartogs' stock to Beck in exchange for 4.2 million in Beck common stock (231a-236a, 342a). As part of the transaction, Mr. Daniels was given a five year employment contract by Beck (267a-274a, 342a). He continued as Hartogs' president until his death in December, 1973 (148a).

Beck's financial collapse

The following facts concerning the rapid deterioration of Beck's financial condition were admittedly known by plaintiff and her husband in 1970 and 1971*:

(i) From February, 1969 to July, 1970 the Beck stock declined from $42.50 per share to $4.50 per share, a drop of $38 per share over an eighteen month period (63a, 342a);

(ii) After learning that a desired public debenture was to be postponed, Beck requested and was granted by the American Stock Exchange a suspension in the trading of its stock in July, 1970 and trading in Beck's stock was never resumed (63a, 342a);

(iii) Beck's officers took various steps to avoid complete financial collapse including meetings with creditors to ob-

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* A distinction has to be drawn between knowledge by plaintiff and her husband of the collapse of the Beck empire on the one hand and the fact that Ernst and Ernst had committed a wrongdoing on the other. As shall be discussed *infra*, knowledge of Beck's subsequent financial difficulties did not as a matter of fact alert plaintiff or her husband to the previous wrongdoing by the independent firm of accountants nor should the former factor be deemed, as held by the Court below, constructive notice of the latter as a matter of law.

tain additional financing and to delay maturity of outstanding obligations (64a), the sale of several subsidiaries to improve liquidity (65a) and a reorganization of top management (65a); and

(iv) Beck petitioned for reorganization under Chapter X of The Federal Bankruptcy Act in May, 1971 (66a-67a).

Thus, in a span of less than two years the assets which Mr. Daniels had invested in Beck and which he had hoped to preserve for his wife and infant son were completely wiped out (321a, 343a).

The acquisition of knowledge by plaintiff that defendant had perpetrated a wrong

Plaintiff has sworn in her opposing affidavit that neither she nor her husband "ever learned of, or even suspected, that Beck's independent certified accountants, Ernst and Ernst, might have been involved in fraudulent practices in connection with the financial statements of Beck Industries until the latter part of December, 1973" (321a). While she concededly suspected that Beck personnel had made misrepresentations, "There was never any reason to believe their independent accounting firm actually played a wrongful role in this situation" (321a). It was not until shortly after her husband's death in December, 1973 that she heard about a law suit that charged Ernst and Ernst "with playing a wrongful role in this situation" (324a).

POINT I

The Court below erred in holding that there was no genuine issue of material fact and in granting defendant summary judgment.

General principles

Under Rule 56, Fed. R. Civ. P., the moving party has the burden of demonstrating the absence of any material factual issue genuinely in dispute (*United States* v. *Pent-R-Books, Inc.*, 538 F.2d 519, 529 [2d Cir. 1976]; *Gladstone* v. *Fireman's Fund Ins. Co.*, 536 F.2d 1403, 1406 [2d Cir. 1976]; *Cali* v. *Eastern Airlines, Inc.*, 442 F.2d 65, 71 [2d Cir. 1971]). This is so because of the "fundamental maxim that on a motion for summary judgment the Court cannot try issues of fact; it can only determine whether there are issues to be tried" (*American Manuf. Mutual Ins. Co.* v. *American Broadcasting-Paramount Theatres, Inc.*, 388 F.2d 272, 279 [2d Cir. 1967]; *Klein* v. *Auchincloss, Parker & Redpath*, 436 F.2d 339, 342 [2d Cir. 1971]; *Heyman* v. *Commerce And Industry Insurance Co.*, 524 F.2d 1317, 1319-20 [2d Cir. 1975]).

These rules are prompted by the very practical consideration that summary judgment is a drastic device "since its prophylactic function, when exercised, cuts off a party's right to present his case to the jury" (*Heyman* v. *Commerce And Industry Insurance Co., supra*, 524 F.2d at p. 1320; *Donnelly* v. *Guion*, 467 F.2d 290, 291 [2d Cir. 1972]). Thus, the summary judgment device "must be used selectively if we are to avoid trial by affidavit" (*Judge* v. *City of Buffalo*, 524 F.2d 1321, 1322 [2d Cir. 1975]).

We submit that there is a triable issue of fact presented on this record that precludes the granting of summary judgment. That pervasive issue is whether plaintiff and

her husband knew or should have known of defendant's wrongdoing prior to April 15, 1972 (three years prior to the commencement of this action).

A.

The financial collapse of Beck Industries should not be deemed actual or constructive notice that an independent firm of accountants had engaged in fraudulent practices.

The main thrust of the decision below is that Beck's financial deterioration should have put plaintiff and her husband on "sufficient notice that further inquiry into Ernst and Ernst's role would be prudent" (347a). We respectfully submit that the Court's postulate is erroneous since it unjustifiably assumes that the financial demise of a corporation *ipso facto* signifies the possibility or probability of a wrongdoing on the part of independent accountants (cf. *Friedlander* v. *Feinberg,* 369 F. Supp. 917 [S.D.N.Y. 1974]), aff'd 508 F.2d 836). Practically speaking, it would seem highly unlikely that the accountancy profession would take kindly to that proposition.

But of even greater importance is the fact that plaintiff has sworn under oath that neither she nor her husband had the slightest suspicion of any wrongdoing by Ernst and Ernst until December, 1973. In effect, the Court below has adversely passed upon the credibility of plaintiff in this regard which the Court had no right to do on this motion for summary judgment (see *Sartor* v. *Arkansas Natural Gas Corp.,* 321 U.S. 620, 627-8; *Subin* v. *Goldsmith,* 224 F.2d 753, 758 [2d Cir. 1955]; *Colby* v. *Klune,* 178 F.2d 872, 873 [2d Cir. 1949]). As this Court wrote in *Cali* v. *Eastern Airlines, Inc., supra,* 442 F.2d at page 71:

> "Moreover, when the court grants summary judgment, it must resolve all ambiguities and draw all

> reasonable inferences favorable to the party against whom summary judgment is sought * * * If undisputed evidentiary facts disclose competing material inferences as to which reasonable minds might disagree, the motion must be denied * * * *'This admonition should especially be kept in mind when the inferences which the parties seek to have drawn deal with questions of motive, intent, and subjective feelings and reactions.'"* (emphasis supplied).

We submit that on this record the issue of constructive notice is one of fact precluding summary judgment. Thus, in *Friedlander* v. *Feinberg,* 369 F. Supp. 917 (S.D.N.Y. 1974), plaintiffs commenced an action predicated, inter alia, on violations of Securities Exchange Commission Rule 10b-5. In essence, plaintiffs, as executors of the estate of Raphael Cohen, claimed that he had been defrauded in his purchase of a limited partnership interest in Drake Associates because of misleading information in a prospectus and because the prospectus failed to set forth information required so as to make statements contained therein not misleading. The prospectus had been furnished to Mr. Cohen in November 1959 and he purchased his partnership interest in February, 1960. His monthly distributions under the terms of the partnership agreement were suspended in March, 1963 after Zeckendorf Hotels Corp. (tenant on a net lease of the sole property owned by Drake Associates) fell into arrears on its rental payments. The various Zeckendorf business interests suffered heavy financial losses at that time. Zeckendorf and his various business entities filed for bankruptcy in July, 1964 and May, 1965. Plaintiffs commenced their action in June, 1970.

In denying defendants' motion for summary judgment, the Court rejected defendant's contention that plaintiffs

had admitted in answers to interrogatories and at depositions that decedent had learned no later than 1965 of the fraudulent conduct in 1959-1960. The Court wrote at page 919:

> "The Court does not agree that these so-called 'admissions' are sufficiently clear and unambiguous to support the conclusion at this stage of the litigation that there are no disputed issues of fact, thereby permitting the dismissal of the complaint as a matter of law."

What the Court then wrote is directly applicable to the case at bar:

> "The essential issue in dispute is whether the possibility of fraud should have been apparent to Mr. Cohen no later than 1965 on the basis of newspaper reports concerning the collapse of the Zeckendorf financial empire and letters sent to Mr. Cohen and other limited partners by the general partners in Drake Associates. Neither of these sources gave an indication of any fraud; *they only gave notice of the financial condition of the several Zeckendorf enterprises as of 1963-1965.* Even though this action is premised upon defendants' alleged misstatements in the 1959 prospectus regarding the financial condition of the Zeckendorf companies at that time, *it requires an inferential leap which this Court is not prepared to make at this time to hold that as a matter of law knowledge in 1963-65 of the poor financial condition of the Zeckendorf companies during that period is sufficient knowledge to have put Mr. Cohen on notice that the financial condition of the Zeckendorf companies as of 1959-60 was misrepresented in the prospectus.* See, Klein v. Auchincloss, Parker & Redpath, 436 F.2d 339 (2d Cir.

> 1971). * * * Under these circumstances, a determination of the time when Raphael Cohen should have discovered that a fraud had been committed must abide additional proof at trial." (emphasis supplied)

This Court affirmed (508 F.2d 836).*

That is this case insofar as the issue of constructive notice is concerned. Just as the newspaper reports and letters concerning the collapse of the Zeckendorf empire subsequent to the issuance of the prospectus did not put plaintiffs in that case on constructive notice of a possible fraud, so, also, in the case at bar the fact that plaintiff and her husband learned in 1970 and 1971 of the financial collapse of the Beck empire did not put them on notice of a possibble fraud in 1968 and 1969.

To paraphrase the *Friedlander* opinion, we respectfully submit that this Court should not indulge in an inferential leap by holding as a matter of law that knowledge in 1970 and 1971 of Beck's poor financial condition was sufficient to have put plaintiff and her husband on notice that Beck's financial condition in 1968 and 1969 was not as represented in the financial statements or reports rendered by Ernst and Ernst.

In *Friedman* v. *Meyers,* 482 F.2d 438 [2d Cir. 1973], plaintiff investor brought an action against promoters and managers of a syndicate for fraudulent diversion and misappropriation of funds. In opposition to defendants' motion for summary judgment on the ground of a statute of limitations, plaintiff swore under oath that she did not discover the 1956 fraud until 1971. In reversing the District Court's granting of summary judgment, this Court wrote at page 439:

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* The record on appeal reveals that the statute of limitations issue was not raised on the appeal.

> "Plaintiff states under oath that she did not discover the 1956 fraud until 1971. Accepting her averment under oath, *as we must in the absence of proof conclusively establishing knowledge*, her action would not be time-barred, since it was instituted within one year of her discovery of the fraud * * *. At this stage, furthermore, dismissal would not be justified on the ground that she may have received papers which would have led an investor to suspect the existence of the true facts. *Suspicion will not substitute for knowledge of facts from which fraud could reasonably be inferred.*" (emphasis supplied)

In *Klein* v. *Auchincloss, Parker & Redpath*, 436 F.2d 339, plaintiff claimed violations under the Securities and Exchange Act of 1934. Regarding a claim under 10(b) of that Act, this Court held that summary judgment should not have been granted against plaintiff. The Court wrote at pages 341-342:

> "It may well be that plaintiff's claim contains no merit. That determination however, is to be made by the finder of fact at trial, and not by the district court on motion for summary judgment * * *. Here there is an issue as to when the claimed fraud was or should have been known to Klein."

B.

The degree of sophistication of plaintiff and her husband is a question of fact.

Within the framework of the primary question as to whether plaintiff and her husband had constructive notice prior to April, 1972 lies the subsidiary question as to just how sophisticated they were regarding investments. The

Court below did "not find persuasive" plaintiff's argument that she and her husband lacked sufficient business sophistication to be put on notice of the fraudulent scheme (347a). We have set forth facts at pages 7-8, *supra*, which could justifiably lead to the conclusion that plaintiff's contention was correct. The issue is for the trier of facts upon a trial.

Thus, in *Dzenits* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 494 F.2d 168 (10th Cir. 1974), plaintiff brought an action against a brokerage house seeking damages by reason of churning of her account (excessive trading by a broker disproportionate to the size of the account involved in order to generate commissions). It is a Rule 10b-5 violation. The District Court granted defendants' motion for summary judgment on the ground that the action was time-barred.

In reversing, the Tenth Circuit Court of Appeals wrote as follows at page 172 on the subject of sophistication vis-a-vis constructive knowledge of the wrongdoing:

> "In each case, the degree of sophistication of the investor is, of course, important *and it is a question of fact.* The plaintiff in Weiser v. Schwartz, supra [286 F. Supp. 389], was the member of the advisory committee of an insurance company as well as a member of the advisory committee of a local bank. Nevertheless, the court in that case determined that notwithstanding his business and financial background, the plaintiff was found to have been an 'unsophisticated investor' since he had made poor investment decisions and had only a dim understanding of what the term churning meant at the time that the securities in his account were actively traded." (emphasis supplied)

Returning to a discussion of the case before it, the Court held (p. 172) that: "At the very least, the issue of plaintiff's knowledge was a question of fact to be determined from a consideration of the evidence."

Similarly in the instant case, the fact that Mr. Daniels was successful in the development of Hartogs because of his artistic abilities is by no means indicative that he was sophisticated with respect to investments. It will be recalled that the "business aspects" of Hartogs was left to his accountants after the death of his father who had overseered it up to the time of his death. Moreover, Mr. Daniels had not previously made any business investments in other companies except for an occasional purchase of stock which was done only on the advice of a stockbroker. Plaintiff was even less sophisticated from a business point of view.

In rejecting plaintiff's contention that she and her husband lacked sufficient business sophistication to be on constructive notice of the fraudulent scheme, the Court below was again passing upon her credibility which it had no right to do on a motion for summary judgment. Defendant offered nothing in their papers that would lead ineluctably to the conclusion that she and her husband were totally sophisticated in every facet of business including investments.

Even assuming *arguendo,* but by no means conceding, that the plaintiff and her husband were sophisticated investors, that does not compel the conclusion that the financial collapse of the Beck empire should have automatically triggered a suspicion on their part that Beck's firm of independent certified accountants may have made material misrepresentations in previous years concerning Beck's then financial status (cf. *Friedman* v. *Meyers,* 482 F.2d 438 [2d Cir. 1973]). The corporate collapse could as logically

have been attributable to poor management, over-acquisition of other companies, a decline in the nation's economy, inflation or any one of many other causes unrelated to Beck's financial condition previously reported upon by Ernst and Ernst. Indeed, the very newspaper items annexed to defendant's moving papers attributed Beck's financial plight to such causes.

Thus, a New York Times article of August 29, 1970 stated (119a);

> "Since last fall, business in many stores across the country has reflected the adverse effect of a slowdown in the economy and consumer shopping hesitancy over inflation, rising prices and, to some extent, fashion changes.
>
> Beck industries, a diversified retailing company which acquired the Liebes chain in an aggressive acquisition program, *has been sharply affected by the business slowdown,* which was reflected in Beck's dwindling profits and a big drop in its shares on the American Stock Exchange." (emphasis supplied)

A New York Times article of August 30, 1970 described how Beck was suffering from "Acquisition Indigestion". The article stated (120a):

> "The reasons for the comings-and-goings of the executives and for the company's financial problems revolve around the acquisition syndrome—the frenzied drive to achieve instant growth and instant earnings by buying companies—which was one of the most dramatic characteristics of American business in the sixties and still continues, if at a diminutive pace, in the seventies.

> In 1969, Beck bought at least 20 companies and committed itself for four more in a program generated by Mr. Glekel and carried out by Mr. McDevitt. But at least four of the acquired companies performed at less than the expected level, *while the slowdown in the economy curbed the parent company's growth generally.*" (emphasis supplied)

The article elaborated on the effect of the decline in the national economy:

> "But what they [Glekel and McDevitt] didn't count on was the sales erosion that ballooned from the decline in the national economy. *If that hadn't happened, Beck could have weathered the unhappy performance in some of the acquisitions. But the combination of the two was too much,* as reflected in the plummeting of the stock and the disinclination of debenture buyers to partake in an issue that could have brought about $15-million." (emphasis supplied)

The article concluded by pointing out that an earlier planned stock offer of 400,000 shares would have realized some twenty million dollars but that it was "called off because of the souring of the stock market".

An article in the Wall Street Journal dated November 24, 1970 quoted Mr. Glekel as stating that Beck had been the victim of tight money, a selloff in the retail business and a poor economy (125a).

Those articles certainly could not have alerted plaintiff or her husband to the possibility of a wrongdoing on the part of Ernst and Ernst; on the contrary, the articles would have reasonably led them to conclude that Beck's collapse was the result of adventitious factors such as inflation, a decline in the economy, tight money and poor

management in the over-acquisition of companies. It cannot be said on the record before this Court that either plaintiff or her husband had or should have had knowledge prior to December, 1973 that would have warranted a different conclusion than that reached by the Times' financial reporter as to the causes of Beck's plight.

Realistically speaking, one of the primary purposes prompting an enterprise like Beck to retain a firm of independent accountants of the stature of Ernst and Ernst was to give prospective investors a feeling of justified security by assuring the public that the enterprise was in the financial condition reported publicly by Ernst and Ernst. That fact, however, does not logically justify the conclusion reached by the Court below that the financial demise of the Beck empire automatically carried with it a duty on the part of investors to deem the firm of independent accountants suspect, especially in light of the fact that newspaper articles indicated that a poor economy and poor management were the causes of Beck's collapse. It is an "inferential leap" that the Courts should not make. Otherwise, to avoid being time-barred a corporate investor would be compelled to conduct an extensive investigation at great, if not prohibitive, cost to himself solely upon the basis of the fact of the corporation's subsequent bankruptcy. The Courts should be wary of imposing that financial onus on an innocent party who has already suffered a severe financial loss (see *Stier* v. *Smith,* 473 F. 2d 1205, 1208 [5th Cir. 1973]).

The totality of circumstances in this case neither raised the specter of, nor fairly excluded any other hypothesis than, the then extremely remote possibility of fraudulent conduct on the part of Ernst and Ernst. Yet, the Court below held essentially to the contrary as a matter of law on the issue of constructive notice. In short, the Court did not, as it should have, accord plaintiff the benefit of

all reasonable inferences, e.g., that until December, 1973 she and her husband had believed, like the newspaper analysis, that Beck's troubles had been caused by poor management and a poor economic atmosphere. It is manifestly unfair to hold that the wrongdoer may escape liability under the technicality of the statute of limitations because plaintiff and her husband did not conduct a financially oppressive investigation at a time when they had no reason to suspect that a wrong had been committed by Beck's independent firm of certified public accountants.

CONCLUSION

Aside the fact that summary judgment should be precluded herein because of the existence of a genuine issue of material fact, there is the further consideration that this case presents a classic example of the statute of limitations being utilized as a sword instead of a shield. The purposes of the statute is to prevent belated vexatious, false or frivolous claims. There is no such danger to be eliminated here. The integrity of the evidence has been maintained and the lapse of time herein does not entail the danger of a false or frivolous claim. There can be no prejudice to defendant in its defense of this action due to the lapse of time.

The order granting summary judgment should be reversed.

Respectfully submitted,

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Attorneys for Plaintiff-Appellant

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